Before ring-fencing

After ring-fencing

**Separating Retail and Investment Banking: Evidence from the UK**

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The views expressed here are those of the authors and do not necessarily reflect the views of the Bank of England or any of its committees.

### Summary

**Should retail and investment banking be separated?**

- Question has been debated at least since 1933 Glass-Steagall Act
- Large regulatory divergences across jurisdictions
- Existing literature has mostly focused on implications of combining corporate lending and underwriting (conflicts of interest, synergies)

We instead focus on a novel deposit funding channel:

- If universal banks must separate retail and investment banking, they cannot use retail deposits to fund investment banking activities
- But wholesale funding is likely to be imperfect substitute for retail deposits
- So this constraint has potential to affect universal banks’ asset allocation decisions

We test this idea using recent UK ring-fencing regulation.

**Main results:**

- Deposit funding channel causes large universal banks to rebalance away from capital market activities and towards retail lending (mortgages)
- These large banks gain market share in retail credit market at expense of smaller competitors
- The smaller banks respond by increasing riskiness of their lending

### Policy

- Ring-fencing requires large banking groups to split into subsidiaries:
  - Retail deposits must be held in Ring-Fenced Bank (RFB)
  - Investment banking must be housed in Non-Ring-Fenced Bank (NRFB)
  - Restrictions on intragroup exposures prevent banks from circumventing the requirements via intragroup contracts
- Legislation passed in 2013; requirements in force from 2019

### Theory

- Retail deposits might benefit from liquidity and/or safety premiums relative to wholesale funding
- Household preferences for liquidity (Stein 2012)
- Deposit insurance (Stein 1996; Hansen et al 2015)
- Market power (Dreheler, Savov and Schnabl 2017)

Ring-fencing implies retail deposits can only fund RFB (primarily retail lending), and cannot fund NRFB (wholesale and investment banking)

- This redirects benefits of deposit funding towards retail lending...
- ...incentivising rebalancing from capital markets to retail lending

### Anecdotal evidence

UK’s 15 biggest mortgage lenders hit by price war

Legislation designed to cut risk in the banking sector has flooded the market with capital

**Financial Times. 2019**

LONDON, Sept 29 (Reuters) - Ring-fencing regulation is increasing the cost and cutting the profitability of syndicated lending for UK banks, which is

**Reuters. 2017**

### Data and identification

**Loan-level data for two markets:**

- Domestic retail mortgages (RFB)
- Global syndicated lending (NRFB)

**Sample period** is run-up to ring-fencing implementation (2010-2019).

Main loan-level regression specification:

\[
\text{Loan}_{i,l,t} = \beta (\Delta \text{Retail funding}_{i,l,t} \times \%\text{(Post)l,t}) + \text{Controls}_{i,l,t} + \epsilon_{i,l,t}
\]

where

- \(\text{Loan}_{i,l,t}\) is price or volume of loan \(l\) originated by bank \(i\) at time \(t\)
- \(\Delta \text{Retail funding}_{i,l,t}\) is change in retail funding ratio as a result of ring-fencing
  - Between-bank variation
  - \(\%\text{(Post)l,t}\) is share of loan maturity that falls after implementation
  - Within-bank variation
  - Captures idea that ring-fencing should have larger effect on loans that remain on balance sheet for longer after funding structure changes
- Controls include bank-time fixed effects (among others)

### Results: Direct effects

**Domestic retail mortgage market (RFB):**

- Affected banks reduce the interest rates on mortgages

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<tbody>
<tr>
<td>(\Delta \text{Retail funding}_{i,l,t} \times %\text{(Post)l,t})</td>
<td>-0.461***</td>
<td>-1.011***</td>
<td>-0.859***</td>
<td>-0.817***</td>
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<td>(0.157)</td>
<td>(0.163)</td>
<td>(0.196)</td>
<td>(0.137)</td>
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<table>
<thead>
<tr>
<th>Controls</th>
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<tr>
<td>Bank-level controls</td>
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<td>Bank-month fixed effects</td>
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<td>Maturity-4TV-month fixed effects</td>
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**Bank-maturity-LTV fixed effects**

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<tr>
<td>Observations</td>
<td>4,576,171</td>
<td>4,528,616</td>
<td>4,518,056</td>
<td>4,324,803</td>
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| R²             | 0.824 | 0.582 | 0.846 | 0.967 |

- This leads to increased mortgage market shares
- Effect is no larger for higher-risk mortgages

**Global syndicated lending market (NRFB):**

- Affected banks reduce provision of syndicated corporate loans
- Effect is larger for loans to foreign borrowers

In sum, results consistent with rebalancing from capital markets (NRFB) to domestic retail lending (RFB)

### Results: Indirect effects

- Universal banks subject to ring-fencing already held dominant position in domestic mortgage market
- Their increased market shares caused by ring-fencing therefore lead to an increase in mortgage market concentration
- Smaller banks more geographically exposed to the increased competitive pressure increase the risk of their lending, consistent with Keeley (1990)

### Policy implications

- Structural separation reduces cost of credit for consumers
- This is not concentrated in high-risk segment, limiting financial stability concerns
- Expansion of consumer credit mirrored by reduction in credit supply to large corporates
- But this is mainly focused on foreign borrowers
- Ambiguous longer-term impact on retail credit market
- Increased market power for larger banks
- Increased risk-taking by smaller banks